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Independent Auditors' Report

Division of Retirement and Benefits
State of Alaska Public Employees' Retirement System:

We have audited the accompanying statements of plan net assets of the State of Alaska Public Employees' Retirement System (Plan), a Component Unit of the State of Alaska, as of June 30, 2004 and 2003, and the related statements of changes in plan net assets for the years then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the plan net assets of the State of Alaska Public Employees' Retirement System, a Component Unit of the State of Alaska, as of June 30, 2004 and 2003, and the changes in plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying required supplementary information of management's discussion and analysis on pages 13 to 19 and schedules of funding progress and employer contributions on pages 39 to 45 are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Schedules 1 and 2 on pages 46 and 47 are presented for the purpose of additional analysis and are not a required part of the basic financial statements. This information is the responsibility of the Plan's management, has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.



The investment, actuarial and statistical data on pages 49 through 91 are presented for the purpose of additional analysis and are not a required part of the basic financial statements of the State of Alaska Public Employees' Retirement System (Plan), a Component Unit of the State of Alaska. Such additional information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

KPMG LLP

September 24, 2004

STATE OF ALASKA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (A Component Unit of the State of Alaska)

Management's Discussion and Analysis

This section presents management's discussion and analysis (MD&A) of the Public Employees' Retirement System's (Plan) financial position and performance for the years ended June 30, 2004 and 2003. This section is presented as a narrative overview and analysis. Please read the MD&A in conjunction with the financial statements, notes to the financial statements, required supplementary and additional information to better understand the financial condition and performance of the Plan during the fiscal years ended June 30, 2004 and 2003. Prior fiscal year information for 2002 is presented for comparative purposes.

Financial Highlights

The Plan's total current assets exceeded its total current liabilities by \$8,177,306,000 and \$7,391,455,000 at the close of Fiscal Years 2004 and 2003, respectively.

The Plan's "Net assets held in trust for pension and postemployment healthcare benefits" as of June 30, 2004 and 2003 increased by \$785,851,000 or 10.6% and decreased by \$21,378,000 or 0.3% over the closing balances of those assets in Fiscal Years 2003 and 2002, respectively.

Plan member and employer contributions received totaled \$224,139,000 and \$211,310,000 during Fiscal Years 2004 and 2003; increases of \$12,829,000 and \$15,912,000 or 6.1% and 8.1% from Fiscal Years 2003 and 2002, respectively.

Net investment income (loss) increased from \$237,205,000 to \$1,064,605,000 during Fiscal Year 2004 and increased from (\$448,279,000) to \$237,205,000 during Fiscal Year 2003; reflecting an increase of 348.8% and 152.9% from Fiscal Years 2003 and 2002, respectively.

Pension benefit and postemployment healthcare payments totaled \$496,750,000 and \$451,015,000 during Fiscal Years 2004 and 2003; reflecting an increase of \$45,735,000 and \$46,479,000 or 10.1% and 11.5% from Fiscal Years 2003 and 2002, respectively.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Plan's basic financial statements. The Plan's basic financial statements are comprised of three components: (1) statement of plan net assets, (2) statement of changes in plan net assets, and (3) notes to the financial statements. This report also contains required supplementary information in addition to the basic financial statements.

Statement of Plan Net Assets – This statement presents information regarding the Plan's assets, liabilities, and net assets. Net assets represent the total amount of assets less the total liabilities. The Statement of Plan Net Assets classifies assets, liabilities and net assets as current, non-current and restricted.

Statement of Changes in Plan Net Assets – This statement presents how the Plan's net assets changed during the fiscal year as a result of contributions, investment income (loss), operating expenses, and changes in net assets.

The above statements represent resources available for investment and the payment of benefits as of the fiscal year-end and the sources and uses of those funds during the fiscal year.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Management's Discussion and Analysis

Notes to the Financial Statements—The notes to the financial statements are an integral part of the financial statements and provide additional detailed information and schedules to better understand the Plan's financial statements.

Required Supplementary Information—The required supplementary information consists of three schedules and related notes concerning the funded status and actuarial assumptions and methods of the Plan.

Other Supplementary Schedules — Other supplementary schedules include detailed information on administrative and investment expenses incurred by the Plan and payments to consultants for professional services.

STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)

Management's Discussion and Analysis

Condensed Financial Information

Public Employees' Retirement System
(000's omitted)

NET ASSETS

Description	2004	2003	Increase/Decrease Amount	%	2002
Assets:					
Cash and receivables	\$ 9,702	9,373	329	3.5%	14,009
Investments, at fair value	8,174,863	7,388,741	786,122	10.6%	7,406,520
Other assets	126	166	(40)	(24.1%)	118
Total assets	8,184,691	7,398,280	786,411	10.6%	7,420,647
Liabilities:					
Accrued expenses	7,281	6,764	517	7.6%	7,395
Other liabilities	104	61	43	70.5%	419
Total liabilities	7,385	6,825	560	8.2%	7,814
Total net assets	\$ 8,177,306	7,391,455	785,851	10.6%	7,412,833

CHANGES IN NET ASSETS

Net assets, beginning of year	\$ 7,391,455	7,412,833	(21,378)	(0.3%)	8,088,382
Additions:					
Contributions	224,139	211,310	12,829	6.1%	195,408
Net investment income (loss)	1,064,605	237,205	827,400	348.8%	(448,279)
Other additions	152	27	125	463.0%	10
Total additions	1,288,896	448,542	840,354	187.4%	(252,861)
Deductions:					
Benefits	496,750	451,015	45,735	10.1%	404,536
Refunds	14,723	13,025	1,698	13.0%	12,869
Administrative expenses	5,296	5,880	(584)	(9.9%)	5,283
Total deductions	516,769	469,920	46,849	10.0%	422,688
Transfer in from					
Retiree Health Fund	13,724	-	13,724	100.0%	-
Increase (decrease) in net assets	785,851	(21,378)	807,229	3776.0%	(675,549)
Net assets, end of year	\$ 8,177,306	7,391,455	785,851	10.6%	7,412,833

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Management's Discussion and Analysis

Financial Analysis of the Plan

The Statement of Plan Net Assets as of June 30, 2004 and 2003 showed total assets exceeding total liabilities by \$8,177,306,000 and \$7,391,455,000. These amounts represent the Plan "Net assets held in trust for pension and postemployment healthcare benefits". The entire amount is available to cover the Plan's obligations to pay pension and postemployment healthcare benefits to its members and their beneficiaries.

These amounts also represent an increase in "Net assets held in trust for pension and postemployment healthcare benefits" of \$785,851,000 or 10.6% and a decrease of \$21,378,000 or 0.3% from Fiscal Years 2003 and 2002. Over the long term, plan member and employer contributions, as well as investment income earned, are expected to sufficiently fund the pension benefit and postemployment healthcare costs of the Plan.

The investment of pension funds is a long-term undertaking. On an annual basis, the Alaska State Pension Investment Board (ASPIB) reviews and adopts an asset allocation strategy to ensure the asset mix will remain at an optimal risk/reward level given the Plan's constraints and objectives. During Fiscal Year 2003, ASPIB adopted an asset allocation that includes 37% in Domestic Equities, 15% in International Equities, 30% in Domestic Fixed Income, 3% in International Fixed Income, 6% in Alternatives, and 9% in Real Estate. This asset allocation is expected to provide a five year median return of 7.72%.

For Fiscal Years 2004 and 2003, the Plan's investments generated 15.08% and 3.67% rate of return, respectively. The Plan's annualized rate of return was 4.09% over the last three years and 3.29% over the last five years.

Actuarial Valuations and Funding Progress

The overall objective of a pension fund is to accumulate sufficient funds to meet all expected future obligations to participants. The contribution requirements are determined as a percentage of eligible salaries, and reflect the cost of benefits accruing in Fiscal Year 2004 and a fixed amortization of the funding target surplus or the unfunded accrued liability. The amortization period is set by the Public Employees' Retirement Board. Contribution levels are recommended by the Actuary and adopted by the Board each year. Investment losses and increasing healthcare costs impacted the Plan's funding ratio as of June 30, 2003 (the date of the Plan's latest actuarial valuation report). The ratio of assets to liabilities decreased from 75.2% to 72.8% during the year, using June 30, 2002 net assets as a base. The goal for the Plan is to have progress toward achieving the funding objectives of the Plan.

A summary of the actuarial assumptions and methods is presented in the Notes to Required Supplementary Information. The assumptions, when applied in combination, fairly represent past and anticipated future experience of the Plan.

The Fiscal Year 2004 employer consolidated rate decreased from 5.43% to 5.42%, the average past service rate was 1.35%, thus producing a total average rate for all employers in the Plan of 6.77%. The Public Employees' Retirement Board adopted an average employer contribution rate of 6.77%.

The Fiscal Year 2005 employer consolidated rate increased from 5.42% to 13.31%, the average past service rate was 11.60%, thus producing a total average rate for all employers in the Plan of 24.91%.

STATE OF ALASKA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (A Component Unit of the State of Alaska)

Management's Discussion and Analysis

The Public Employees' Retirement Board adopted an average employer contribution rate of 11.77%.

Valuation Year	(000's omitted)	
	2003	2002
Valuation Assets	\$7,687,281	7,412,833
Accrued Liabilities	10,561,653	9,859,591
Funding ratio	72.8%	75.2%

Contributions and Investment Income (Loss)

The revenues required to finance retirement benefits are accumulated through a combination of employer and plan member contributions and investment income.

	Revenues				
	(000's Omitted)		Inc/(Dec)		
	FY04	FY03	Amt	%	FY02
Plan Member Contributions	\$ 118,554	112,112	6,442	5.7%	100,639
Employer Contributions	105,585	99,198	6,387	6.4%	94,769
Net Investment Income (Loss)	<u>1,064,605</u>	<u>237,205</u>	<u>827,400</u>	348.8%	<u>(448,279)</u>
Total	\$1,288,744	448,515	840,229	187.3%	(252,871)

Plan member contributions increased from \$112,112,000 in Fiscal Year 2003 to \$118,554,000 during Fiscal Year 2004, an increase of \$6,442,000 or 5.7%. Employer contributions increased from \$99,198,000 during Fiscal Year 2003 to \$105,585,000 during Fiscal Year 2004, an increase of \$6,387,000 or 6.4%.

Investment income in Fiscal Year 2004 increased by \$827,400,000 or 348.8% from amounts recorded in Fiscal Year 2003. Investment income in Fiscal Year 2003 increased by \$685,484,000 or 152.9% over amounts recorded in Fiscal Year 2002. The equity markets continued their strong performance

during the last quarter of Fiscal Year 2003 into the first three quarters of Fiscal Year 2004. However, the last quarter of Fiscal Year 2004 proved to be flat, posting an overall investment return of -0.07%.

Benefits, Refunds, and Expenses

The primary expense of the Plan is the payment of pension benefits. These benefit payments, together with postemployment healthcare premiums paid, lump sum refunds made to former plan members and the cost of administering the Plan comprise the costs of operations.

	(000's Omitted)		Expenses		FY02
	FY04	FY03	Amt	%	
Pension Benefits	\$ 329,390	307,684	21,706	7.1%	279,731
Healthcare Benefits	167,360	143,331	24,029	16.8%	124,805
Refunds of Contributions	14,723	13,025	1,698	13.0%	12,869
Administrative Expenses	5,296	5,880	(584)	(9.9%)	5,283
Total	\$ 516,769	469,920	46,849	10.0%	422,688

Pension benefit payments in 2004 and 2003 increased \$21,706,000 and \$27,953,000 or 7.1% and 10.0% from Fiscal Years 2003 and 2002, respectively. The majority of the increase in pension benefits was the result of a continuing increase in the number of retirees. The Plan's board did not grant a discretionary cost-of-living (ad hoc post retirement pension adjustment (ad hoc PRPA)) increase for Fiscal Year 2004.

Postemployment healthcare benefits in 2004 and 2003 increased \$24,029,000 and \$18,526,000 or 16.8% and 14.8% from Fiscal Years 2003 and 2002, respectively. Healthcare costs continue to rise in amounts exceeding 10% year over year and the

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Management's Discussion and Analysis

increase is also directly related to the increased number of retirees in the Plan.

Funding

Retirement benefits are financed by accumulations from employer and plan member contributions and income earned on the Plan's investments.

- Employer contributions are determined by the Plan's consulting actuaries and approved by the Plan's governing board.
- Plan member contributions are determined by statute.
- ASPIB works in conjunction with the Department of Revenue, Division of Treasury, in determining the proper asset allocation strategy.

Legislation

During the Fiscal Year 2004 legislative session, one law was enacted that affected the Plan:

Senate Bill 232 – The purpose of this bill is to (1) assure that the teachers' retirement system, the public employees' retirement system, and the judicial retirement system continue to meet governmental plan qualifications set by the Internal Revenue Service so that those plans may qualify for a favorable federal tax treatment; and (2) implement changes in those retirement systems for members to take advantage of changes in federal tax laws to better plan their retirement.

Economic Conditions, Future Contribution Rates, and Status of Unfunded Liability

During the period July 1, 2003 to March 31, 2004, the Plan's investments continued to make great

strides to the upside, a continuation of the Fiscal Year 2003's last quarter performance. The last quarter of Fiscal Year 2004 proved to be flat by returning -0.07%. Overall, the Plan's investments returned 15.08% for the year. The Plan did exceed its' actuarially assumed investment return of 8.25% for the first time in over three years. Even with the real investment returns exceeding the actuarial rate of return, the Plan will most likely see an increase in employer contribution rates in Fiscal Year 2007. The employer contribution rate for Fiscal Year 2007 will be announced by May 2005.

The financial market environment continues to challenge investors. With the threat of inflation, interest rate increases by the Federal Reserve Bank, and continued turmoil in the Middle East, many forces once again pose challenges to Plan investments. ASPIB continues to diversify the portfolio of the Plan to maintain an optimal risk / reward ratio.

The impact of Fiscal Year 2001 and 2002's decline on the Plan's market value, returns less than the actuarial rate of return in Fiscal Year 2003, and the additional impacts of increasing healthcare premiums paid to the Retiree Health Fund continue to weigh on the Plan's funding ratio and the employer contribution rates. Typically, when the Plan earns less than the actuarial rate of return, the effect is an increase to the employer contribution rate. This was the case in Fiscal Year 2003, which impacts the Plan's funding status as of June 30, 2003 as well as the Fiscal Year 2005 employer contribution rate. Due to investment deficiencies, demographic experiences greater than valuation assumptions, and the contribution shortfall compared to the actuarially calculated rate, the June 30, 2003 actuarial valuation report for the Plan's reported a funding ratio of 72.8%, down from Fiscal Year 2002's funding ratio of 75.2%.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Management's Discussion and Analysis

With the decline in the funding ratio, the consulting actuary recommended an increase from the average employer contribution rate of 24.91% in Fiscal Year 2005 to 25.63% in Fiscal Year 2006. The PERS board adopted an average employer contribution rate of 16.77% for Fiscal Year 2006, up 5 points from the Fiscal Year 2005 employer contribution rate of 11.77%. The primary reason for the five (5) point change in the average matching employer contribution rate from 11.77% to 16.77% is due to the Plan's regulation, 2 AAC 35.900 Maximum Employer Contribution Rate Change, which states "(T)he maximum change in the contribution rate from one year to the next shall be no more than five percentage points, as actuarially calculated, whether the change is an increase or a decrease." Despite a modest 0.72 point change in the calculated average employer contribution rates from Fiscal Year 2005 to 2006 prescribed by the Plan's consulting actuary, regulations prohibit more than a five point change from year to year, so the Board was limited in its capacity to increase the PERS board adopted

employer rates to a rate capped at 16.77%. This regulation was put in place to reduce the volatility that employer contribution rates could have in market conditions similar to the past couple of years, as well as conditions that are beyond the control of the Plan, such as rising healthcare costs. However, even with the five point increase to 16.77%, employers are paying only a little less than two-thirds of the average total employer contribution rate of 25.63% in Fiscal Year 2006.

Requests for Information

This financial report is designed to provide a general overview of the Plan's finances for all those with interest in the Plan's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Alaska Public Employees' Retirement System, Division of Retirement & Benefits, Accounting Section, P.O. Box 110203, Juneau, Alaska 99811-0203.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Statements of Plan Net Assets

**June 30, 2004 and 2003
(000's omitted)**

	2004			2003		
	Post-employment			Post-employment		
	Pension	Healthcare	Total	Pension	Healthcare	Total
Current assets:						
Cash and cash equivalents (notes 3 and 4):						
Short-term fixed income pool	\$ 359	152	511	369	155	524
Receivables:						
Contributions	6,457	2,734	9,191	6,220	2,620	8,840
Retirement Incentive Program employer contributions (note 8)	-	-	-	7	2	9
Total receivables	6,457	2,734	9,191	6,227	2,622	8,849
Investments, at fair value (notes 3 and 4):						
Domestic equity pool	2,453,196	845,777	3,298,973	2,210,167	764,062	2,974,229
Retirement fixed income pool	1,025,053	434,004	1,459,057	986,806	415,586	1,402,392
International equity pool	958,337	405,757	1,364,094	811,591	341,794	1,153,385
Real estate pool	441,475	186,619	628,394	364,096	153,337	517,433
International fixed income pool	208,994	88,487	297,481	193,697	81,574	275,271
Private equity pool (note 9)	189,148	80,085	269,233	152,079	64,046	216,125
Emerging markets equity pool	69,676	29,501	99,177	52,442	22,085	74,527
External domestic fixed income pool	527,115	231,179	750,294	545,603	229,776	775,379
Other investment pool	5,733	2,427	8,160	-	-	-
Total investments	5,878,727	2,296,136	8,174,863	5,316,481	2,072,260	7,388,741
Loans and mortgages, at fair value, net of allowance for loan losses of \$16 in 2004 and 2003	83	36	119	99	42	141
Other	5	2	7	17	8	25
Total assets	5,885,631	2,299,060	8,184,691	5,323,193	2,075,087	7,398,280
Current liabilities:						
Accrued expenses	5,115	2,166	7,281	4,759	2,005	6,764
Due to State of Alaska General Fund	71	31	102	44	17	61
Alaska Department of Commerce escrow liability	2	-	2	-	-	-
Total liabilities	5,188	2,197	7,385	4,803	2,022	6,825
Commitments and Contingencies (note 9)						
Net assets held in trust for pension and postemployment healthcare benefits	\$5,880,443	2,296,863	8,177,306	5,318,390	2,073,065	7,391,455

(Schedules of funding progress are presented on pages 39 and 40.)

See accompanying notes to financial statements.

STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)

Statements of Changes in Plan Net Assets

June 30, 2004 and 2003
(000's omitted)

	2004			2003		
	Pension	Post-employment Healthcare	Total	Pension	Post-employment Healthcare	Total
Additions:						
Contributions:						
Employers	\$ 74,178	31,407	105,585	69,801	29,397	99,198
Plan members	83,290	35,264	118,554	78,889	33,223	112,112
Total contributions	157,468	66,671	224,139	148,690	62,620	211,310
Investment income:						
Net appreciation in fair value of investments (note 3)	591,306	250,357	841,663	9,723	4,094	13,817
Interest	82,927	35,111	118,038	87,690	36,930	124,620
Dividends	87,121	36,886	124,007	80,905	34,073	114,978
Net recognized mortgage loan recovery	-	-	-	50	21	71
Total investment income	761,354	322,354	1,083,708	178,368	75,118	253,486
Less investment expense	13,421	5,682	19,103	11,457	4,824	16,281
Net investment income	747,933	316,672	1,064,605	166,911	70,294	237,205
Other	107	45	152	19	8	27
Total additions	905,508	383,388	1,288,896	315,620	132,922	448,542
Deductions:						
Benefits	329,390	167,360	496,750	307,684	143,331	451,015
Refunds of contributions	10,344	4,379	14,723	9,165	3,860	13,025
Administrative expenses	3,721	1,575	5,296	4,138	1,742	5,880
Total deductions	343,455	173,314	516,769	320,987	148,933	469,920
Net increase (decrease)	562,053	210,074	772,127	(5,367)	(16,011)	(21,378)
Other financing sources (uses):						
Transfer in from Retiree Health Fund (note 7)	-	13,724	13,724	-	-	-
Net increase (decrease)	562,053	223,798	785,851	(5,367)	(16,011)	(21,378)
Net assets held in trust for pension and postemployment healthcare benefits:						
Balance, beginning of year	5,318,390	2,073,065	7,391,455	5,323,757	2,089,076	7,412,833
Balance, end of year	<u>\$5,880,443</u>	<u>2,296,863</u>	<u>8,177,306</u>	<u>5,318,390</u>	<u>2,073,065</u>	<u>7,391,455</u>

See accompanying notes to financial statements.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

(1) DESCRIPTION

The following brief description of the State of Alaska Public Employees' Retirement System (Plan), a Component Unit of the State of Alaska, is provided for general information purposes only. Participants should refer to the Plan agreement for more complete information.

(a) General

The Plan is a defined benefit, agent, multiple employer public employee retirement system established and administered by the State of Alaska (State) to provide pension and postemployment healthcare benefits for eligible State and local government employees. Benefit and contribution provisions are established by State law and may be amended only by the State Legislature. The Plan is considered a component unit of the State financial reporting entity and is included in the State's financial reports as a pension trust fund. The State employees who administer the Plan participate in the Plan.

At June 30, 2004 and 2003, the number of participating local government employers and public organizations including the State was:

	<u>2004</u>	<u>2003</u>
State of Alaska	1	1
Municipalities	79	78
School districts	53	53
Other	<u>28</u>	<u>28</u>
	<u>161</u>	<u>160</u>

Inclusion in the Plan is a condition of employment for eligible State employees, except, as otherwise provided, for judges, elected officers and certain employees of the Alaska Marine Highway System. Any local government in the State may elect to have its permanent general and police and fire department employees covered by the Plan. At June 30, 2003 and 2002, the dates of the two most recent actuarial valuations, which included Plan membership data, Plan membership consisted of:

	<u>2003</u>	<u>2002</u>
Retirees and beneficiaries currently receiving benefits	18,431	17,215
Terminated Plan members entitled to future benefits	<u>5,841</u>	<u>5,702</u>
	<u>24,272</u>	<u>22,917</u>
Current Plan members:		
General	31,338	30,547
Police and fire	<u>2,727</u>	<u>2,695</u>
	<u>34,065</u>	<u>33,242</u>
	<u>58,337</u>	<u>56,159</u>
Current Plan members:		
Vested:		
General	16,369	16,944
Police and fire	1,739	1,715
Nonvested:		
General	14,969	13,603
Police and fire	<u>988</u>	<u>980</u>
	<u>34,065</u>	<u>33,242</u>

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

(b) Pension Benefits

Employees hired prior to July 1, 1986, with five or more paid-up years of credited service are entitled to monthly pension benefits beginning at normal retirement age, fifty-five, or early retirement age, fifty. For employees first hired after June 30, 1986, the normal and early retirement ages are sixty and fifty-five, respectively. Employees with thirty or more years of credited service (twenty years for peace officers and firefighters) may retire at any age and receive a normal benefit.

The normal monthly pension benefit is based on years of service and average monthly compensation. For employees hired prior to July 1, 1996, and all police and fire employees, the average monthly compensation is based upon the employees' three highest, consecutive years salaries. For all other employees hired after June 30, 1996, average monthly compensation is based upon the employees' five highest, consecutive years salaries.

The benefit related to all years of service prior to July 1, 1986, and for years of service through a total of ten years for general employees is equal to 2% of the employee's average monthly compensation for each year of service. The benefit for each year over ten years of service subsequent to June 30, 1986, is equal to 2-1/4% of the employee's average monthly compensation for the second ten years and 2-1/2% for all remaining years of service. For police and fire employees, the benefit for years of service through a total of ten years is equal to 2% of the employee's average monthly compensation and 2-1/2% for all remaining years of service.

Minimum benefits for employees eligible for retirement are \$25 per month for each year of credited service.

Married members must receive their benefits in the form of a joint and survivor annuity unless their spouses consent to another form of benefit or another person is eligible for benefits under a qualified domestic relations order.

The Plan has two types of postretirement pension adjustments (PRPA). The automatic PRPA is issued annually to all eligible benefit recipients, when the cost of living increases in the previous calendar year. The automatic PRPA increase is paid beginning July 1 of each year. The discretionary PRPA may be granted to eligible recipients by the Plan Administrator, if the cost of living in the previous calendar year rises and the financial condition of the Plan permits. If both an automatic and discretionary PRPA are granted, and a retiree is eligible for both adjustments, the one that provides the retiree the greater increase will be paid.

(c) Postemployment Healthcare Benefits

Major medical benefits are provided to retirees without cost for all employees hired before July 1, 1986. Employees hired after July 1, 1986 with five years of credited service (or ten years of credited service for those first hired after July 1, 1996) must pay the full monthly premium if they are under age sixty, and receive benefits at no premium cost if they are over age sixty or are receiving disability benefits. Police and fire employees with 25 years of membership service also receive benefits at no premium cost.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

Prior to July 1, 1997, postemployment healthcare benefits were provided by the payment of premiums to an insurance company. Beginning July 1, 1997, the Retiree Health Fund (RHF), a pension trust fund of the State, was established. The RHF is self-funded and provides major medical coverage to retirees of the Plan. Retirees of three other State retirement plans also participate in the RHF. The Plan, along with the other participating plans, retains the risk of loss of allowable claims. Each year, RHF issues a publicly available financial report, which may be obtained by writing to the State of Alaska, Department of Administration, Division of Retirement and Benefits, P.O. Box 110203, Juneau, Alaska, 99811-0203 or by calling (907) 465-4460.

(d) Death Benefits

If an active other Plan member dies from occupational causes, the spouse may receive a monthly pension equal to 40% of the Plan member's salary. If an active police and fire Plan member dies from occupational causes, the spouse may receive a monthly pension equal to 50% of the Plan member's salary or 75% of the member's retirement benefit calculated as if the member had survived until normal retirement age, whichever is greater. When death is due to occupational causes and there is no surviving spouse, the Plan member's dependent child(ren) may receive the monthly pension until they are no longer dependents. The amount of the occupational death pension changes on the date the Plan member's normal retirement would have

occurred if the Plan member had lived. The new benefit is based on the Plan member's average monthly compensation at the time of death and the credited service, including service that would have accrued if the Plan member had lived and continued to work until normal retirement. If the death was from nonoccupational causes, and the Plan member was vested, the spouse may receive a monthly survivor benefit based on a 50% joint and survivor option. If the Plan member is not married or vested, a lump sum death benefit is payable to the named beneficiary(ies).

(e) Disability Benefits

Active Plan members who become permanently disabled due to occupational or nonoccupational causes receive disability benefits until normal retirement age or when the service requirement for normal retirement is met. Although there are no minimum service requirements for Plan members to be eligible for occupational disability, Plan members must be vested to receive nonoccupational disability benefits. The monthly occupational disability benefit is equal to 40% of the Plan member's salary at the time of the disability. The nonoccupational disability benefit is based on the Plan member's service and salary at the time of disability. At normal retirement age, a disabled other Plan member receives normal retirement benefits. A police and fire Plan member may elect to receive normal retirement benefits calculated under the occupational disability benefit rules.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

(f) Contributions

Plan Member Contributions

Contribution rates are 7.5% for peace officers and firefighters, 9.6% for some school district employees, and 6.75% for other Plan members, as required by statute. The Plan member contributions are deducted before federal income tax is withheld. Contributions are collected by employers and remitted to the Plan and may be voluntarily or, under certain circumstances, involuntarily refunded to the employee or a garnishing agency sixty days after termination of employment. Plan member contributions earn interest at the rate of 4.5% per annum, compounded semiannually.

Employer Contributions

The Plan's funding policy provides for periodic employer contributions at actuarially determined rates that, expressed as percentages of annual covered payroll, are sufficient to accumulate assets to pay both pension and postemployment healthcare benefits when due. Employer contribution rates are level percentages of payroll and are determined using the projected unit credit actuarial funding method. The Plan uses the level percentage of pay method to amortize the unfunded liability or the funding surplus over a twenty-five year fixed period.

(g) Administrative Costs

Administrative costs are financed through investment earnings.

(h) Due To/From State of Alaska General Fund

Amounts due to/from the State of Alaska General Fund represent the net difference between amounts paid by the Plan on behalf of others and amounts paid by others on behalf of the Plan.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Accounting

The Plan's financial statements are prepared using the economic resources measurement focus and the accrual basis of accounting. Contributions are recognized in the period in which they are due. Benefits and refunds are recognized when due and payable.

(b) Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of additions and deductions during the reporting period. Actual results could differ from those estimates.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

(c) GASB Statements No. 25 and No. 26

Government Accounting Standards Board (GASB) Statements No. 25 and No. 26 require that plan net assets be split between pension and postemployment healthcare. To meet these requirements, plan assets, liabilities, revenues and expenses not specifically identifiable to either plan are allocated to the pension and postemployment healthcare plans based on their proportionate share of actuarial accrued liabilities.

(d) Investments

Investments are recorded at fair value. Fair value is "the amount that a plan can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller – that is, other than in a forced or liquidation sale." Security transactions and any resulting gains or losses are accounted for on a trade date (ownership) basis at the current fair value. Dividend income on domestic and international equity securities is accrued on the ex-dividend date. Interest in the international fixed income pool is accrued daily. Net appreciation (depreciation) is determined by calculating the change in the fair value of investments between the end of the year and the beginning of the year, less purchases of investments at cost, plus sales of investments at fair value. Investment expense consists of those administrative expenses directly related to the Plan's investment operations.

As the emerging markets equity pool recognizes income, the per share value changes,

resulting in the recognition of unrealized gains/losses at the pool and participant level. When participants' shares in the pool are sold, previously unrealized income is realized at the participant level.

Income in the short-term fixed income pool is calculated daily and credited monthly to each participant. Total income, which includes interest and realized and unrealized gains and losses on securities, is calculated daily and distributed monthly to each participant on a pro rata basis.

Income in the retirement fixed income pool and the external domestic fixed income pool is calculated daily and is reinvested. Total income, which includes interest and realized and unrealized gains and losses on securities, is allocated daily to each participant on a pro rata basis but is not distributed.

Real estate investments include commingled real estate equities, separate account limited partnerships, mortgage loans and other real estate acquired by foreclosure and judgments. Commingled real estate equities and separate account limited partnerships are valued quarterly by public market quotations, where a quoted market exists, or by independent appraisers, and are periodically adjusted by trustees of the investments when market conditions change. The cost of commingled real estate equities and separate account limited partnerships securities is determined on the average cost basis. Mortgage loans are valued at their principal balance (cost) less an allowance for loan loss, the net result of which approximates fair value. The allowance for loan loss is considered by

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

management to be sufficient to cover any losses to the mortgage loan portfolio. Real estate acquired by foreclosure and judgments is carried at estimated net realizable value.

Venture capital investments in the private equity pool are comprised of limited partnerships in privately held companies of which equity ownership is not traded on a national or international exchange. Investments in the private equity pool are valued quarterly by the general partners and investment sponsors. The private equity oversight manager is held to a standard of reasonable care in verifying that the general partners' valuations reasonably reflect the underlying value of the investments. The cost of investments in the private equity pool is determined on the average cost basis.

The Plan holds shares, rather than specific securities, in the emerging markets equity pool, a closed-end mutual fund-like commingled equity investment pool. Underlying securities within the pool are priced on the last business day of each week and each month. Equity securities are valued using the last reported sale price on the exchange on which the securities are traded as of the close of business on the day the securities are being valued, or, in the absence of any sales price, at the last reported bid price. Fixed income securities are valued at prices obtained from a bond pricing service when such prices are available; otherwise, such securities are valued at the mid-point between the bid and asked price or at prices for securities of comparable maturity, quality and type. Short-term

securities with 60 days or less to maturity are amortized to maturity based on cost. Securities expressed in terms of foreign currencies are translated into U.S. dollars at the prevailing market rates. Forward currency contracts are valued at the mid-point of representative quoted bid and asked prices. Securities and assets for which representative market quotations are not readily available are valued at fair value as determined in good faith under policies approved by the commingled equity fund's board of directors.

The fair value of all other debt and equity securities is determined by the custodial agent each business day. The custodian determines fair value using pricing services or prices quoted by one or more independent brokers. Equity securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates, if applicable, defaulting to current bid price if a particular security was not traded that day. Fair value of debt securities has been established as the midpoint between the bid and asked prices. The cost of debt and equity investments is determined on the average cost basis.

(e) Contributions Receivable

Contributions from plan members and employers for service through June 30 are accrued. These contributions are considered fully collectible and, accordingly, no allowance for uncollectible receivables is reflected in the financial statements.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

(f) Federal Income Tax Status

The Plan is a qualified plan under Section 401(a) of the Internal Revenue Code and is exempt from federal income taxes under Section 501(a).

(g) GASB Statement No. 34

The Plan adopted Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* (GASB No. 34) on July 1, 2001, concurrent with the State of Alaska's adoption of GASB No. 34. This statement, known as the "reporting model" statement, affects the way the Plan presents financial information. GASB No. 34 requires the basic financial statements of fiduciary funds to include statements of plan net assets and statements of changes in plan net assets. Modifications made to the Plan's financial reporting model as a result of the adoption of GASB No. 34 include presentation of management's discussion and analysis (as required supplementary information) and presentation of assets and liabilities in a classified format. The adoption of GASB No. 34 had no cumulative effect on net assets.

(3) INVESTMENTS

GASB Statement No. 3 requires a disclosure regarding custodial credit risk to indicate the chance of loss in the event a financial institution or third party holding the Plan's deposits or securities fails. Deposits and those investments represented by specific, identifiable securities are classified into three categories of credit risk: Category 1 – Insured or registered, or securities held by the State or its custodian in the State's name; Category 2 – Uninsured or unregistered, with securities held by the counterparty's trust department (if a bank) or agent in the State's name; and Category 3 – Uninsured and unregistered, with securities held by the counterparty, or by its trust department (if a bank) or agent, but not in the State's name. Category 1 is the highest level of safekeeping security as defined by GASB.

At June 30, 2004 and 2003, the Plan's cash and cash equivalents and investments other than mortgage-related assets are represented by participation in investment pools rather than specific, identifiable securities. Although pooled investments represent the Plan's share of ownership in the pool rather than ownership of specific securities, all of the underlying securities in the pools in which the Plan participates are considered to be Category 1 as defined by GASB Statement No. 3. Shares in the Emerging market equity, Private equity, Real estate equity, and Other investments pools are not transferable financial instruments and therefore cannot be categorized with regard to custodial credit risk.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

The cost and fair value of the Plan's investments at June 30, 2004 and 2003 are as follows:

	<u>Cost</u>	<u>Fair Value</u>
2004:		
Domestic equity pool	\$ 2,855,031	3,298,973
Retirement fixed income pool	1,471,701	1,459,057
International equity pool	1,341,813	1,364,094
Real estate pool	587,151	628,394
International fixed income pool	272,320	297,481
Private equity pool	329,777	269,233
Emerging markets equity pool	92,092	99,177
External domestic fixed income pool	752,291	750,294
Other investments pool	<u>8,122</u>	<u>8,160</u>
	<u>\$ 7,710,298</u>	<u>8,174,863</u>
2003:		
Domestic equity pool	\$ 2,879,386	2,974,229
Retirement fixed income pool	1,345,983	1,402,392
International equity pool	1,368,516	1,153,385
Real estate pool	478,080	517,433
International fixed income pool	241,082	275,271
Private equity pool	295,669	216,125
Emerging markets equity pool	91,005	74,527
External domestic fixed income pool	<u>757,370</u>	<u>775,379</u>
	<u>\$ 7,457,091</u>	<u>7,388,741</u>

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

During 2004 and 2003, the Plan's investments (including investments bought, sold, as well as held during the year) appreciated (depreciated) in value as follows:

	<u>2004</u>	<u>2003</u>
Investments measured by quoted fair values in an active market:		
Domestic equity pool	\$ 525,916	(26,722)
Retirement fixed income pool	(65,161)	68,371
International equity pool	321,070	(98,684)
Real estate pool	10,796	6,929
International fixed income pool	7,836	44,907
Private equity pool	40,053	(33,551)
Emerging markets equity pool	23,562	3,847
External domestic fixed income pool	(22,448)	48,720
Other investments pool	<u>39</u>	<u>-</u>
	<u>\$ 841,663</u>	<u>13,817</u>

Based on the Plan's percentage of ownership in each investment pool as of June 30, 2004 and 2003, the Plan held no individual investments that exceeded 5% of net assets held in trust for pension and postemployment healthcare benefits.

The Alaska State Pension Investment Board (ASPIB) has statutory oversight of the Plan's

investments and the authority to invest the Plan's monies. As the fiduciary, ASPIB has the statutory authority to invest the assets under the Prudent Investor Rule. Alaska Statute provides that investments shall be made with the judgment and care under circumstances then prevailing that an institutional investor of ordinary professional prudence, discretion and intelligence exercises in managing large investment portfolios. Actual investing is performed by the investment officers of the Division of Treasury of the Department of Revenue or by contracted external investment managers.

(4) POOLED INVESTMENTS

(a) Short-Term Fixed Income Pool

The Plan, along with other State funds, participates in an internally managed short-term fixed income pool, which was established March 15, 1993, with a start up and maintained share price of \$1. Each participant owns shares in the pool, the number of which fluctuates daily with contributions, withdrawals and income. The assets of the short-term fixed income pool are comprised of money market instruments, U.S. Treasuries, mortgage and asset-backed securities, corporate debt and other U.S. dollar denominated bonds. Individual fixed rate securities in this pool are limited to 14 months in maturity. Floating rate securities are limited to three years in maturity. At June 30, 2004 and 2003, the Plan has a 0.03% direct ownership in the short-term fixed income pool totaling \$511 and \$524, respectively. These amounts include interest receivable of \$5 and \$8, respectively.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

(b) Domestic Equity Pool

The Plan, along with three other State retirement systems, participates in an externally managed domestic equity pool. The pool was established July 1, 1991, with a start up share price of \$1,000. The share price at June 30, 2004 was \$4,086. Each manager independently determines the allocation between equity and other permissible securities. Ownership in the pool is based on the number of shares held by each participant. The net asset value per share is determined by dividing the total fair value of the net assets of the pool by the number of shares of the pool outstanding on the valuation date. Contributions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At June 30, 2004 and 2003, the Plan's investment in the domestic equity pool totaled 67.20% and 66.84%, respectively, and consisted of the following:

	<u>2004</u>	<u>2003</u>
Domestic equity securities	\$3,265,803	2,942,732
Convertible bonds	526	2,051
Cash and cash equivalents held in the short-term fixed income pool, other short-term debt instruments, and currency	31,183	28,723
Net receivables	1,461	723
	<u>\$3,298,973</u>	<u>2,974,229</u>

(c) Retirement Fixed Income Pool

The Plan, along with three other State retirement systems, participates in an externally managed retirement fixed income pool. The pool was established March 1, 1996, with a start up share price of \$1,000. The share price at June 30, 2004 was \$1,723. Treasury division staff determines the allocation between permissible securities. Ownership in the pool is based on the number of shares held by each participant. The net asset value per share is determined by dividing the total fair value of the net assets of the pool by the number of shares of the pool outstanding on the valuation date. Contributions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At June 30, 2004 and 2003, the Plan's investment in the retirement fixed income pool totaled 67.03% and 66.69%, respectively, and consisted of the following:

	<u>2004</u>	<u>2003</u>
Mortgage related	\$ 725,257	623,423
Corporate	351,933	393,174
U.S. Treasury	202,047	172,370
Yankees	12,642	14,089
Municipal	-	15,701
Asset backed	45,486	73,366
U.S. government agency	63,076	68,382
Cash and cash equivalents held in the short-term fixed income pool	109,481	191,825
Net payables	(50,865)	(149,938)
	<u>\$1,459,057</u>	<u>1,402,392</u>

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

(d) International Equity Pool

The Plan, along with three other State retirement systems, participates in an externally managed international equity pool. The pool was established January 1, 1992, with a start up share price of \$1,000. The share price at June 30, 2004 was \$2,312. Each manager independently determines the allocation between equities and other permissible securities. Ownership in the pool is based on the number of shares held by each participant. The net asset value per share is determined by dividing the total fair value of the net assets of the pool by the number of shares of the pool outstanding on the valuation date. Contributions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At June 30, 2004 and 2003, the Plan's investment in the international equity pool totaled 67.46% and 67.01%, respectively, and consisted of the following:

	<u>2004</u>	<u>2003</u>
International equity securities	\$1,343,014	1,134,731
Cash and cash equivalents held in short-term debt instruments and foreign currency	14,925	18,468
Net receivables	<u>6,155</u>	<u>186</u>
	<u>\$1,364,094</u>	<u>1,153,385</u>

(e) Real Estate Pool

The Plan, along with one other State retirement system, participates in an externally managed real estate pool. The pool was established June 27, 1997, with a start up share price of \$1,000. The share price at June 30, 2004 was \$1,807. Ownership in the pool is based on the number of shares held by each participant. The net asset value per share is determined by dividing the total fair value of the net assets of the pool by the number of shares of the pool outstanding on the valuation date. Contributions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At June 30, 2004 and 2003, the Plan has 67.54% and 66.88% direct ownership in the real estate equity pool totaling \$628,394 and \$517,433, respectively.

(f) International Fixed Income Pool

The Plan, along with one other State retirement system, participates in an externally managed international fixed income pool. The pool was established March 3, 1997, with a start up share price of \$1,000. The share price at June 30, 2004 was \$1,630. Each manager independently determines the allocation between permissible securities. Ownership in the pool is based on the number of shares held by each participant. The net asset value per share is determined by dividing the total fair value of the net assets of the pool by the number of shares of the pool outstanding on the valuation date. Contribu-

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

tions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At June 30, 2004 and 2003, the Plan's investment in the international fixed income pool totaled 67.32% and 66.98%, respectively and consisted of the following:

	<u>2004</u>	<u>2003</u>
International fixed income securities	\$ 288,456	266,857
Cash and cash equivalents held in short-term debt instruments and foreign currency	2,991	3,030
Net receivables	<u>6,034</u>	<u>5,384</u>
	<u>\$ 297,481</u>	<u>275,271</u>

(g) Private Equity Pool

The Plan, along with one other State retirement system, participates in an externally managed private equity pool. The pool was established April 24, 1998, with a start up share price of \$1,000. The share price at June 30, 2004 was \$1,156. Underlying assets in the pool are composed of venture capital, buyouts and special situation investments through limited partnership agreements. Ownership in the pool is based on the number of shares held by each participant. Contributions to and withdrawals from the pool are based on the beginning of the day net

asset value per share on the day of the transaction. At June 30, 2004 and 2003, the Plan has a 67.68% and 67.32% ownership in the private equity pool totaling \$269,233 and \$216,125, respectively.

(h) Emerging Markets Equity Pool

The Plan, along with one other State retirement system, participates in an emerging markets equity pool. The pool was established May 2, 1994, with a start up share price of \$1,000. The share price at June 30, 2004 was \$1,438. The pool participates in two externally managed commingled investment funds through ownership of equity shares. The commingled funds, comprised of various institutional investors, invest in the securities markets of developing countries. Ownership in the pool is based on the number of shares held by each participant. The net asset value per share is determined by dividing the total fair value of the net assets of the pool by the number of shares of the pool outstanding on the valuation date. Contributions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At June 30, 2004 and 2003, the Plan has a 65% ownership in the emerging markets equity pool totaling \$99,177 and \$74,527, respectively.

(i) Other Investments Pool

The Plan, along with one other State retirement system, participates in an externally managed other investments pool. The pool was established March 18, 2004 with a start up share price

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

of \$1,000. The share price at June 30, 2004 was \$1,006. The underlying asset in the pool is composed of a limited partnership interest in a venture capital operating company. The venture capital operating company invests in oil, gas and other hydrocarbon properties, operations or projects as well as electric and other forms of power generation, transmission and distribution and other power-related projects or operations. Ownership in the pool is based on the number of shares held by each participant. Contributions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At June 30, 2004, the Plan has a 67.68% ownership in the other investments pool totaling \$8,160.

(j) External Domestic Fixed Income Pool

The Plan, along with three other State retirement systems, participates in an externally managed domestic fixed income pool. The pool was established June 25, 1999, with a start up share price of \$1,000. The share price at June 30, 2004 was \$1,448. Each manager independently determines the allocation between permissible securities. Ownership in the pool is based on the number of shares held by each participant. The net asset value per share is determined by dividing the total fair value of the net assets of the pool by the number of shares of the pool outstanding on the valuation date. Contributions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At

June 30, 2004 and 2003, the Plan's investment in the external domestic fixed income pool totaled 66.73% and 66.32%, respectively and consisted of the following:

	<u>2004</u>	<u>2003</u>
Mortgage related	\$309,517	344,769
Corporate	141,037	154,372
U.S. Treasury	168,072	71,338
U.S. government		
agency	66,023	51,603
Asset backed	24,954	25,005
Yankees	14,039	8,620
Municipal	-	9,578
Cash and cash		
equivalents held		
in short-term debt		
instruments	151,960	254,036
Net payables	<u>(125,308)</u>	<u>(143,942)</u>
	<u>\$ 750,294</u>	<u>775,379</u>

**(5) FOREIGN EXCHANGE CONTRACTS
AND OFF-BALANCE SHEET RISK**

The Plan, through its investments in the international equity pool and the international fixed income pool, entered into foreign currency forward contracts to buy and sell specified amounts of foreign currencies at specified rates on specified future dates for the purpose of hedging existing security positions. The maturity periods for these contracts range from forty-five to ninety-six days. The Plan had net unrealized gains

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

(losses) with respect to such contracts, calculated using forward rates at June 30 as follows:

	<u>2004</u>	<u>2003</u>
Net contract sales	\$ 4,981	1,003
Less: fair value	<u>5,312</u>	<u>990</u>
Net unrealized gains (losses) on contracts	<u>\$ (331)</u>	<u>13</u>

The counterparties to the foreign currency forward contracts consist of a diversified group of financial institutions. The Plan is exposed to credit risk to the extent of non-performance by these counterparties; however, the Plan considers the risk of default to be remote. The Plan's market risk is limited to the difference between contractual rates and forward rates at the balance sheet date.

(6) SECURITIES LENDING

Alaska Statute 37.10.071 authorizes the Alaska State Pension Investment Board (the Board) to lend assets, under an agreement and for a fee, against deposited collateral of equivalent market value. In January 2001, the Board entered into an agreement with State Street Corporation (the Bank) to lend fixed income, domestic equity, and international equity securities. The Bank, acting as the Board's agent under the agreement, transfers securities to broker agents or other entities for collateral in the form of cash or securities and simultaneously agrees to return the collateral for the same securities in the future.

At June 30, 2004 and 2003, the fair value of securities on loan allocable to the Plan totaled \$960,292 and \$624,928, respectively. There is no limit to the amount that can be loaned and the Board is able to sell securities on loan. International equity security loans are fully collateralized at not less than 105 percent of their fair value. All other security loans are fully collateralized at not less than 102 percent of their fair value. The Bank invests the cash collateral in a commingled investment pool; maturities of these investments generally did not match the maturities of the loaned securities because the lending agreements are terminable at will. The Bank may pledge or sell collateral upon borrower default. Since the Board does not have the ability to pledge or sell the collateral unless the borrower defaults, no assets or liabilities are recorded on the financial statements. There is limited credit risk associated with the lending transactions since the Board is indemnified by the Bank against any loss resulting from counterparty failure or default on a loaned security subject to limitation relating to war, civil unrest or revolution, or beyond the reasonable control of the Bank. The Bank and the borrower receive a fee from earnings on invested collateral.

For the years ended June 30, 2004 and 2003, there were no losses incurred as a result of securities lending transactions and there were no significant violations of legal or contractual provisions nor failures by any borrowers to return loaned securities.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

(7) TRANSFER TO RETIREMENT SYSTEMS

During Fiscal Year 2004, a review was conducted of all medical reserve amounts. An analysis was conducted which considered: (1) the medical portion of net assets held in trust for benefits and other purposes, (2) prior and current year amounts incurred but not paid, (3) the amount necessary for the contingency reserve, and (4) the amount necessary for a premium stabilization reserve. The result was an excess computed amount of net assets not specifically identified to other reserves. The excess amount was then moved back to the respective retirement system. There is an earnings differential on invested assets between the base trust fund and the Plan. Earnings on such excess reserves should remain with the base retirement trust. Such an analysis is conducted periodically to determine that reserves are adequate, but not excessive.

Based on this review, the Plan transferred \$20,000,000 to the four contributing retirement systems. The transfers were made in the following manner:

Public Employees'	
Retirement System	\$ 13,724,000
Teachers' Retirement System	6,200,000
Judicial Retirement System	50,000
Elected Public Officials	
Retirement System	26,000

(8) RETIREMENT INCENTIVE PROGRAM

House Bill 354 (Chapter 65, SLA 96) was passed on June 18, 1996, and provided for a retirement

incentive program (RIP or program) for members of school district employers and employees of Mt. Edgecumbe and the Alaska Vocational Technical Center. The RIP encouraged eligible employees to retire up to three years earlier than they had planned as a cost savings to the employer. The incentive program could be implemented if the program produced an overall cost savings to the employer. The application and retirement deadlines were determined by the employer when they established a program. The original application period for employees under House Bill 354 was June 30, 1996 through December 31, 1996. During fiscal year 1997, Senate Bill 130 (Chapter 92, SLA 97) was passed which amended the original program. Senate Bill 130 allowed for additional application periods on an "as needed basis" anytime through June 30, 1999.

Senate Bill 1003 (Chapter 4, FSSLA 96) was passed on June 28, 1996, and provides for a RIP for employees of the State, the University of Alaska and all employers other than school districts. Under this legislation, the State and University of Alaska could open a RIP application period on an "as needed basis" anytime between July 18, 1996 and June 30, 1999. The program was designed to allow State agencies to use the RIP in a strategic, targeted approach tailored to the specific budget and personnel situation of each agency. Some State agencies could determine that the RIP was not cost-effective for their agency and elect not to participate in the RIP. Other agencies offered the RIP only in divisions or job classifications facing budget reductions or position cuts.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

Employers who participated in either of the RIP programs were required to reimburse the Plan for the actuarial equivalent of the difference between the benefits each employee received after the addition of the retirement incentive under the program and the amount the employee would have received without the incentive, less any amount the employee was indebted as a result of retiring under the program. Reimbursements from employers were due in minimum equal annual installments so that the entire balance was paid within three years after the end of the fiscal year in which each employee retired. Employers were also required to reimburse the Plan for the estimated costs of administering the program. The Plan established a receivable for employer reimbursements and administrative costs as employees retire. There were no additions to plan net assets during fiscal year 2004 or 2003.

When employees terminated employment to participate in the program, they were indebted to the Plan for the following percentages of their annual compensation for the calendar year in which they terminated:

Police and fire members	22.50%
Other members	20.25%

Any outstanding indebtedness at the time an employee was appointed to retirement resulted in an actuarial adjustment of his/her benefit amount.

(9) COMMITMENTS AND CONTINGENCIES

(a) Commitments

The Plan, through its investment in the private equity pool, entered into agreements through an external investment manager to provide capital funding for limited and general partnerships as it continues to build a private equity portfolio. At June 30, 2004, the Plan's share of these unfunded commitments totaled \$321,598 to be paid through the year 2009.

The Plan, through its investment in the other investments pool, entered into agreements through an external investment manager to provide capital funding for a limited partnership as it continues to build an other investments portfolio. At June 30, 2004, the Plan's share of these unfunded commitments totaled \$46,023 to be paid through the year 2014.

The Plan, through its investment in the real estate pool, entered into agreements through an external investment manager to provide capital funding for real estate investments as it continues to build a real estate portfolio. At June 30, 2004, the Plan's share of these unfunded commitments totaled \$66,350 to be paid through the year 2007.

(b) Contingencies

The State and/or the Plan are defendants in the following lawsuits. The Plan has not recorded an accrual related to any of the lawsuits, because an unfavorable outcome in these matters

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Notes to Financial Statements

**June 30, 2004 and 2003
(000's omitted)**

is, in management's opinion, not considered probably but rather only possible, and the potential loss, if any cannot be reasonably estimated at this time. If an unfavorable outcome occurs, the costs would be passed through to employers through the normal contribution process.

The State is a defendant in a lawsuit filed by the Alaska Civil Liberties Union and seven same-sex couples with regards to the statutes limiting employee health insurance coverage to employees and their spouses and dependents, thus excluding coverage for domestic partners of employees. An adverse ruling against the State would increase the number of persons that would be covered by insurance paid by the Plan.

The Plan is a defendant in four similar lawsuits, three of which are class action suits. The lawsuits pertain to whether recent changes to the retiree health insurance program under the Plan resulted in violations of members' constitutional rights to retirement benefits. In 2001, the Superior Court of the State of Alaska issued an order granting the plaintiffs' motion for partial summary judgment.

Approximately 50 Plan members have filed administrative challenges to the Plan administrator's refusal to include leave cash-in

payments in the compensation used to calculate the members' retirement benefits. The members were all first hired by Plan employers before July 1, 1977, and claim that they have a constitutional right, based on the Plan statutes in effect before that date, to have leave cash-in payments included. The Plan board, which hears appeals from decisions of the Plan administrator, has ruled on two of the appeals, and those rulings have in turn been appealed to the Alaska Superior Court. The remaining appeals have been stayed by the Plan board. In addition, a class action lawsuit, raising the same issues, has been filed in the superior court, but has been put on hold until final resolution of the members' claim. The administrator intends to vigorously contest all of these claims.

The State is a defendant in a class action lawsuit involving a constitutional challenge to PERS and TRS statutes that provide a 10 percent cost of living adjustment (COLA) to retirees and other benefit recipients who reside in the state of Alaska. The plaintiffs claim that these statutes violate the right to travel of non-resident benefit recipients, and therefore, the 10 percent COLA should be paid to all benefit recipients, regardless of residence. The class action lawsuit will be submitted to the Alaska Supreme Court to consider the constitutionality of the COLA statutes and how they are applied.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

**Required Supplementary Information
(Unaudited)**

**Schedule of Funding Progress
Pension Benefits**

**June 30, 2004 and 2003
(000's omitted)**

Actuarial valuation year ended June 30	Actuarial value of plan assets	Actuarial accrued liabilities (AAL)	Funded excess (FE)/ (Unfunded actuarial accrued liabilities) (UAAL)	Funded ratio	Covered payroll	FE/(UAAL) as a percentage of covered payroll
1998	\$4,692,095	4,430,237	261,858	105.9%	\$1,235,439	21.2%
1999	4,992,453	4,730,841	261,612	105.5%	1,283,549	20.4%
2000	5,245,612	5,190,835	54,777	101.1%	1,321,480	4.1%
2001	5,579,440	5,528,026	51,414	100.9%	1,208,700	4.3%
2002	4,611,170	6,133,182	(1,522,012)	75.2%	1,245,054	(122.2%)
2003	4,607,673	6,330,541	(1,722,868)	72.8%	1,300,041	(132.5%)

See accompanying notes to required supplementary information and independent auditors' report.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

**Required Supplementary Information
(Unaudited)**

**Schedule of Funding Progress
Postemployment Healthcare Benefits**

**June 30, 2004 and 2003
(000's omitted)**

Actuarial valuation year ended June 30	Actuarial value of plan assets	Actuarial accrued liabilities (AAL)	Funding excess (FE)/ (Unfunded actuarial accrued liabilities) (UAAL)	Funded ratio	Covered payroll	FE/(UAAL) as a percentage of covered payroll
1998	\$1,879,467	1,773,754	105,713	105.9%	\$1,235,439	8.6%
1999	2,023,887	1,917,832	106,055	105.5%	1,283,549	8.3%
2000	2,209,146	2,186,077	23,069	101.1%	1,321,480	1.7%
2001	2,362,316	2,340,548	21,768	100.9%	1,208,700	1.8%
2002	2,801,663	3,726,409	(924,746)	75.2%	1,245,054	(74.3%)
2003	3,079,608	4,231,112	(1,151,504)	72.8%	1,300,041	(88.6%)

See accompanying notes to required supplementary information and independent auditors' report.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

**Required Supplementary Information
(Unaudited)**

**Schedule of Employer Contributions
Pension and Postemployment Healthcare Benefits**

**June 30, 2004 and 2003
(000's omitted)**

Year ended June 30	Pension annual required contribution	Postemployment healthcare annual required contribution	Total annual required contribution	Pension percentage contributed (note 3)	Postemployment healthcare percentage contributed (note 3)	Total percentage contributed (note 3)
1999	\$69,337	27,860	97,197	100.0%	100.0%	100.0%
2000	63,344	25,740	89,084	105.2%	105.2%	105.2%
2001	65,151	26,477	91,628	105.3%	105.3%	105.3%
2002	65,485	26,613	92,098	102.9%	102.9%	102.9%
2003	63,283	26,651	89,934	110.3%	110.3%	110.3%
2004	74,178	31,407	105,585	100.0%	100.0%	100.0%

See accompanying notes to required supplementary information and independent auditors' report.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

**Notes to Required Supplementary Information
(Unaudited)**

**June 30, 2004 and 2003
(000's omitted)**

**(1) DESCRIPTION OF SCHEDULE OF FUNDING
PROGRESS**

Each time a new benefit is added which applies to service already rendered, an "unfunded actuarial accrued liability" is created. Laws governing the Plan require that these additional liabilities be financed systematically over a period of future years. Also, if actual financial experiences are less favorable than assumed financial experiences, the difference is added to the unfunded actuarial accrued liability.

In an inflationary economy, the value of the dollar is decreasing. This environment results in employee pay increasing in dollar amounts resulting in unfunded actuarial accrued liabilities increasing in dollar amounts, all at a time when the actual value of these items, in real terms, may be decreasing.

(2) ACTUARIAL ASSUMPTIONS AND METHODS

The actuarial valuation is prepared by Mercer Human Resource Consulting. The significant actuarial assumptions used in the valuations as of June 30, 2003 are as follows:

- (a) Actuarial cost method—projected unit credit, unfunded actuarial accrued liability or funding excess amortized over a rolling twenty-five year fixed period level percentage of pay.
- (b) Mortality basis – 1994 Group Annuity Mortality Basic Table for males and females, 1994 base year. Deaths are assumed to be occupational 85% of the time for police and

fire members, 35% of the time for other members.

- (c) Retirement – retirement rates based on the 1997-1999 actual experience.
- (d) Investment return – 8.25% per year, compounded annually, net of expenses.
- (e) Health cost trend –

Fiscal Year	
04-05	12.0%
06	11.5%
07	11.0%
08	10.5%
09	10.0%
10	9.5%
11	9.0%
12	8.5%
13	8.0%
14	7.5%
15	7.0%
16	6.0%
FY17 and later	5.0%

- (f) Salary scale – inflation 3.5%, productivity and merit (first five years) for police and fire members, 1.0% and 1.5%, respectively, and for all other members, productivity and merit (first ten years) 0.5% and 1.5%, respectively.
- (g) Total inflation – total inflation as measured by the Consumer Price Index for urban and clerical workers for Anchorage is assumed to increase 3.5% annually.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

**Notes to Required Supplementary Information
(Unaudited)**

**June 30, 2004 and 2003
(000's omitted)**

- (h) Cost of living allowance (domicile in Alaska) – 68% of those benefit recipients who are eligible for the allowance are assumed to remain in Alaska and receive the allowance.
- (i) Contribution refunds – 100% of those employees terminating after age thirty-five who are vested will leave their contributions in the Plan and thereby retain their deferred vested benefit. All others who terminate are assumed to have their contributions refunded.
- (j) Disability – incidence rates based upon the 1991-1995 actual experience of the Plan. Post-disability mortality in accordance with rates published by the Pension Benefit Guaranty Corporation to reflect mortality of those receiving disability benefits under Social Security.
- (k) Asset valuation method – recognize 20% of the investment gains and losses in each of the current and preceding four years and phased in over the next five years. All assets are valued at market value. Valuation assets cannot be outside a range of 80% to 120% of the market value of assets.
- (l) Valuation of medical benefits for retirees – a pre-age sixty-five cost and lower post-age sixty-five cost (due to Medicare) are assumed such that the total rate for all retirees equals the present premium rate assumption. These medical premiums are then increased with the health cost inflation assumption.
- (m) Spouse's age – wives are assumed to be four years younger than husbands.
- (n) Dependent children – benefits to dependent children have been valued assuming members who are not single have one dependent child.
- (o) Post-retirement pension adjustment – 50% and 75% of assumed inflation is valued for the automatic Post-Retirement Pension Adjustment (PRPA) as specified by statute.
- (p) Expenses – expenses are covered in the investment return assumption.
- (q) Total turnover – based upon the 1997-1999 actual withdrawal experience.
- (r) Part-time status – part time employees are assumed to earn 0.600 years of credited service per year.
- (s) New entrants – growth projections are made for the active PERS population under three scenarios:
- | | |
|--------------|-------------|
| Pessimistic: | 0% per year |
| Median: | 1% per year |
| Optimistic: | 2% per year |
- The assumptions and methods, when applied in combination, fairly represent past and anticipated future experience of the Plan. The foregoing actuarial assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial as-

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

**Notes to Required Supplementary Information
(Unaudited)**

**June 30, 2004 and 2003
(000's omitted)**

sumptions and other factors might be applicable in determining the actuarial present value of accumulated benefits.

All significant accounting policies, benefit provisions and actuarial assumptions are the same for the required supplementary information and the financial statements except as follows:

Effective June 30, 2000, the following changes were made:

- The mortality basis was changed from the 1984 Unisex Pension Mortality Table to the 1994 Group Annuity Mortality Basic Table, 1994 base year.
- The turnover assumptions were revised based on actual withdrawal experience in 1997-1999.
- The retirement age assumptions were revised based on actual experience in 1997-1999.
- The health cost trend assumptions were changed for fiscal years 2009 and later from an ultimate rate of 4.5% for fiscal years 2009-2013 and 4% for all subsequent fiscal years.
- The salary scale assumptions were changed. The inflation assumption was changed to 3.5% from 4%, the productivity and merit (first five years) assumptions of 0.5% and 1%, respectively, were broken out for police/fire members and other members.

Productivity and merit (first five years) for police/fire members and other members were set at 1% and 1.5%, and 0.5% and 1.5%, respectively.

- The total inflation assumption was changed from 4% to 3.5%.
- The cost of living allowance was decreased from 71% to 68%.
- Disabilities are no longer assumed to be occupational 85% of the time for police and fire members and 35% for other members.
- The percentage used to reduce the actuarial value of assets in the target unfunded (surplus) accrued liability calculation was increased to 2.343757% from 2.296%.
- For the June 30, 2000 actuarial valuation, data as of June 30, 1999 was projected one year using standard actuarial techniques. The active population count was assumed to increase by 1.72% (quadratic extrapolation over the most recent 3 valuation dates). Actual CPI data was used to estimate new PRPA benefits for participants retired as of June 30, 1999.

Effective June 30, 2001 the following changes were made:

- The percentage used to reduce the actuarial value of assets in the target unfunded (surplus) accrued liability calculation was increased to 3.381643% from 2.343757%.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

**Notes to Required Supplementary Information
(Unaudited)**

**June 30, 2004 and 2003
(000's omitted)**

Effective June 30, 2002, the following changes were made:

- The target-funding ratio was changed from 102% to 100%.
- The actuarial cost method was changed from a rolling twenty-five year period to a twenty-five year fixed period level percentage of pay.
- The salary scale assumptions were changed. Productivity rates (first five years) for police/fire members were set at 1.0% from 0.5%.
- Part-time employees are assumed to earn 0.600 years of credited service per year.
- The health cost trend assumptions were changed for fiscal years 2003 and later from an ultimate rate of 12.0% for fiscal years 2003-2005 decreasing in yearly 0.5% increments to 5.0% beginning in 2017 and all subsequent fiscal years.
- The asset valuation method was changed to recognize 20% of the investment gains and losses in each of the current and preceding four years and will be phased in over the next five years.

(3) ENHANCED ACTUARIAL PROJECTION SYSTEM

The Plan's actuary, at the request of the Public Employees Retirement Board, uses an enhanced actuarial projection system to determine annual employer contribution rates. Although the same actuarial cost method is used by the Plan's actuary, the enhanced system projects population growth patterns and their associated liabilities twenty-five years into the future.

The purpose of the enhanced actuarial projection system is to level out contribution rates in order to provide employers with a more stable long-term contribution pattern.

The Plan's utilization of the enhanced actuarial projection system resulted in 1998-1999 employer contributions being equal to the annual required contribution and 2000-2003 employer contributions being more than the annual required contribution.

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

Schedule of Administrative and Investment Expenses

**Year ended June 30, 2004
with comparative totals for 2003
(000's omitted)**

	<u>Administrative expenses</u>	<u>Investment expenses</u>	<u>Totals</u>	
			<u>2004</u>	<u>2003</u>
Personal services:				
Wages	\$ 2,215	851	3,066	3,020
Benefits	<u>861</u>	<u>307</u>	<u>1,168</u>	<u>1,429</u>
Total personal services	<u>3,076</u>	<u>1,158</u>	<u>4,234</u>	<u>4,449</u>
Travel:				
Transportation	34	46	80	110
Per diem	28	36	64	99
Moving	-	-	-	6
Honorarium	<u>18</u>	<u>15</u>	<u>33</u>	<u>34</u>
Total travel	<u>80</u>	<u>97</u>	<u>177</u>	<u>249</u>
Contractual services:				
Management and consulting	429	16,591	17,020	14,002
Accounting and auditing	22	793	815	922
Other professional services	772	64	836	677
Data processing	214	26	240	265
Communications	227	29	256	336
Advertising and printing	117	214	331	274
Rentals/leases	104	11	115	309
Legal	1	67	68	77
Medical specialists	29	-	29	48
Repairs and maintenance	15	1	16	9
Transportation	2	2	4	6
Other services	<u>113</u>	<u>16</u>	<u>129</u>	<u>103</u>
Total contractual services	<u>2,045</u>	<u>17,814</u>	<u>19,859</u>	<u>17,028</u>
Other:				
Equipment	-	11	11	151
Supplies	<u>95</u>	<u>23</u>	<u>118</u>	<u>284</u>
Total other	<u>95</u>	<u>34</u>	<u>129</u>	<u>435</u>
Total administrative and investment expenses	<u>\$ 5,296</u>	<u>19,103</u>	<u>24,399</u>	<u>22,161</u>

See accompanying independent auditors' report.

Schedule 2

**STATE OF ALASKA
PUBLIC EMPLOYEES' RETIREMENT SYSTEM
(A Component Unit of the State of Alaska)**

**Schedule of Payments to Consultants
Other than Investment Advisors**

**Years ended June 30, 2004 and 2003
(000's omitted)**

<u>Firm</u>	<u>Services</u>	<u>2004</u>	<u>2003</u>
State Street Corporation	Custodian banking services	\$ 942	849
Deloitte and Touche LLP	Benefits consultation	148	76
Mercer Human Resource Consulting	Actuarial services	316	317
Milliman USA	Actuarial audit	-	46
Systems Central Services, Inc.	Data processing consultants	214	199
State of Alaska, Department of Law	Legal services	253	155
Mikunda, Cottrell & Co., Inc.	PERS Board elections	-	110
Wohlforth, Vasser, Johnson and Brecht	PERS Board legal services	25	51
Cost Effectiveness Measurement	Cost study	-	25
First National Bank of Alaska	Banking services	25	24
KPMG LLP	Auditing services	<u>22</u>	<u>106</u>
		<u>\$ 1,945</u>	<u>1,958</u>

See accompanying independent auditors' report.

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